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As to obsolescence

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the client of the importance of such measures usually brings the necessary approval and co-operation.

Audit procedure, especially with respect to funds, must needs be left to the judgment of the accountant. The client as a rule is quick, when it is explained to him, to see the wisdom of this course and to realize that an auditor who is free and untrammeled in his methods has a greater opportunity of rendering effective service. Since the service is in behalf of the client whatever benefit accrues from the unrestricted exercise of the auditor's ability accrues to the client. Again, proper explanation of the necessity of this course and proper arrangement with the client usually result in hearty co-operation.

As to Obsolescence

THE past has heard much talk of obsolescence. Definitions of depreciation usually include it as an element thereof. Admittedly it has been difficult to measure. Notwithstanding such difficulty the element has been recognized generally. Something of a jolt therefore may reasonably be felt when some court comes forth with a decision, in effect, that there is no such thing, as happened in the case of Pacific Gas and Electric Company vs. City and County of San Francisco. In this case the court failed to allow an adequate return for obsolescence of equipment caused by installation of more efficient patented devices. But the Supreme Court of the United States came to the rescue of accounting theory when, on June 2, 1924, it reversed the decision of the lower court.

A statement of the case and quotations from the decision follow:

"The company is the sole producer and distributor of gas in the San Francisco district. By municipal ordinances the company was directed to supply gas at not more than 75 cents per thousand feet. Claiming that this rate would not yield a fair return, the company brought suit. The suit was referred to a master who recommended dismissal of the suit. The court below affirmed the master's report. The master applied the 'modified sinking fund method,' involving an estimate of the life of the property and an annual allowance for future replacement on a 5 per cent. compound interest basis. In this connection the master said: 'It is assumed that loss of plant units by obsolescence and inadequacy, as well as by physical decay, can be forecast with substantial accuracy and provided for in advance of abandonment and replacement.' The company objected to this method, insisting that depreciation should be ascertained upon consideration of the definite testimony of competent experts who made estimates on observed conditions. The company claimed that in order to lower the cost of production it became necessary to abandon certain valuable property under conditions not reasonably susceptible of anticipation. The company also claimed that the master failed properly to appraise certain patent rights through which manufacturing costs had been greatly reduced and that he failed to make proper allowance for the successful use of such rights.

"In reversing the lower court, the Supreme Court said in part: 'Obviously, under the theory accepted below, appellant worsened the situation for rate making purposes when it reduced the cost of manufacturing gas. Introduction of successful patented inventions enabled the public authorities to lower the rate base and gather all the benefits. The operating plant, made capable of producing gas at smaller cost, was declared less valuable than before. The result indicates error

somewhere, either in theory or in application of principle. Obsolescence of one or more stations and perhaps other property theretofore of great value (possibly $800,000) followed installation of the patents, but the remaining plant plus the patents gave better results. As an operating unit the new combination had greater value than the old; but the court below disregarded the demonstrated worth of the element which wrought this change. The obsolescence in question did not result from ordinary use and wear. Certainly it could not have been long anticipated—the patents were of recent conception; to provide for it out of previous revenues was not imperative, if possible. Former consumers were not beneficiaries; only subsequent ones could be advantaged. Our concern is with confiscation. Rate-making is no function of the courts; their duty is to inquire concerning the results and uphold the guaranties which inhibit the taking of private property for public use without just compensation under any guise. * * * * After adopting the reduced costs of manufacture for estimating net returns, the court gave no proper valuation to the inventions which caused the reduction, and thereby permitted property to be taken without just compensation. The amount of money actually paid to the inventors was not the proper measure of worth. Experience had demonstrated a much higher one; and to obtain the benefits of their use appellant sacrificed much. Installation of the inventions necessitated new outlay of money and abandonment of property theretofore valuable—both were necessary in order that the cost of manufacture might be reduced. If appellant's permissible profits depend upon the lowered cost and it is denied adequate return upon property which made the reduction possible, or recompense for the obsolescence, successful efforts to improve the service will prove extremely disadvantageous to it. * * * * ' The cause was remanded to the lower court for further proceedings."

Is It Possible?

CONVENTION plays such an important part in affairs generally that even accounting does not escape its grasp. The conventional balance sheet has certain specifications, though in many respects financial statements are far from having reached a standardized stage. One of these notable particulars is the manner of expressing capital stock having a fixed par value. Convention requires that the capital of a corporation having capital stock of this kind shall be represented as the par value of its stock even though some nominal asset like good will has to be created to take up the slack between real value received and the par value of stock issued in exchange therefor. The reason for the practice can be traced to those laws which make stockholders liable for assessment under certain circumstances for the difference between value given by them and the par value of their stock.

Now comes a corporation organized under the laws of Virginia, having preferred and common issues, both with par value and a comparatively small surplus, which wishes to redeem the entire preferred issue at a premium out of the proceeds of further sales of common and charge the premium against the common capital stock account instead of against surplus.

The conventionalists would, of course, raise their hands in holy horror, but thoughtful consideration of the matter seems to find no reason why it should not be done; provided it is done in the proper way.